CIA/OER EIWA 74/02/21 JAPAN: MARKED SLOWDOWN AHEAD

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Annex to

Economic Intelligence Weekly

Japan: A Marked Slowdown Ahead

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JAPAN: A MARKED SLOWDOWN AHEAD

1. Japan will experience its sharpest economic slowdown since the mid-1950s this year but will still do better than most developed countries. We estimate that real output will grow by 3%-5%, compared with a long-term average of more than 10%. Before the oil crisis, we expected a 9% gain in 1974.

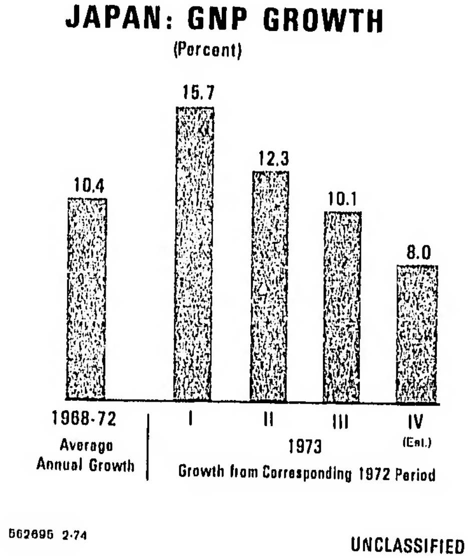
2. Drastically increased prices for imported oil are largely responsible for the change in economic outlook. The anticipated rise in oil import costs of at least $11 billion this year will be a major drain on domestic purchasing power. Foreign demand for Japanese goods also will be hurt because huge oil import bills promise to slow economic growth in most developed countries. Aggregate demand thus will weaken considerably unless the government takes strong compensatory action.

3. Because oil supplies are still below normal and spiraling inflation remains a major concern, Tokyo will move cautiously in switching from its present restrictive policies to stimulative ones. Prime Minister Tanaka's political position has already been seriously weakened by an average 12% rise in consumer prices last year, and Minister of Finance Fukuda—who aspires to the top position—clearly wants to bring inflation under control even at some cost in economic growth. Japanese economic growth this year is unlikely to reach 5%—the upper point of the estimated range—unless strong expansionary measures are introduced by mid-year.

Recent Trends

4. After reaching a 14% rate in the first half of 1973, Japan's real growth slipped markedly in the third and fourth quarters. The pinch on oil supplies starting in November forced a slight decline in industrial output, growth of which had been slowing since mid-year because of capacity constraints. Oil deliveries to Japan during the fourth quarter were about 10% below normal. Overall demand remained strong despite slackening growth in government spending and inventory accumulation.

5. The already high inflation rate has accelerated in recent months. By January, consumer prices were nearly 25% above the January 1973 level, while wholesale prices increased by 35% as shortages proliferated and costs of imported raw materials continued to surge. Rising labor costs were not a major factor, because the exceptional 17% gain in productivity last year nearly offset the average wage increase. Japan's unit labor costs rose less than those in almost any other industrial country.

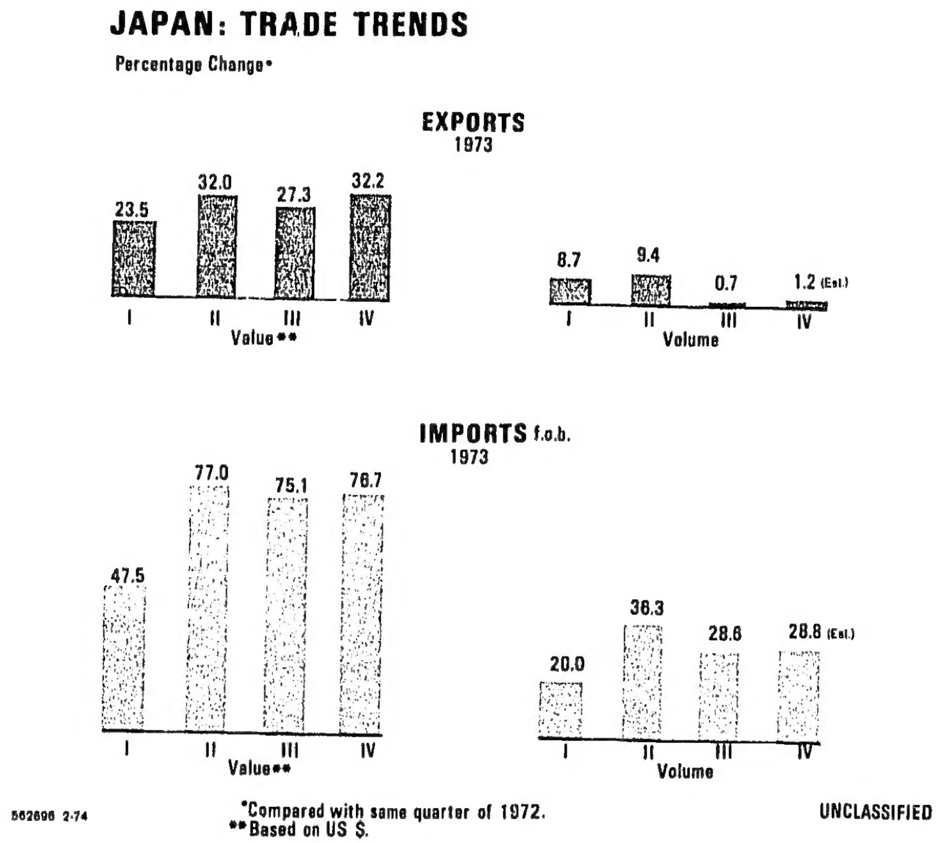


6. Alarmed by spiraling prices, the government has gradually moved to the most restrictive monetary and fiscal policies in several years. Nominal growth in the money supply slowed considerably from April through October. In late December, the discount rate was hiked by 2 percentage points, and in January the authorities placed severe quantitative limits on bank lending. These anti-inflationary moves basically reflect the views of Minister of Finance Fukuda, who took the post in late November. Long known as a conservative, he sees inflation as the most serious threat to Japan's economy and hopes that success in controlling it will help him become the next prime minister.

7. Japan's trade surplus continued to decline during the second half of 1973, primarily as a result of strong import demand and lack of goods to sell abroad. Export volume in the second half of 1973 was little higher than in the second half of 1972. The drop in the 1973 trade surplus to $3.7 billion—about 40% of the 1972 level—did not deter Tokyo from encouraging long-term capital outflows. On a net basis, these outflows amounted to $9.7 billion last year, a world record. The resulting heavy demand for dollars placed strong downward pressure on the yen beginning in October; by early January the Central Bank had sold nearly $5 billion worth of dollars on the Tokyo money market. The yen nonetheless depreciated sharply—almost returning to the Smithsonian rate before strengthening this month.

Prospects for 1974

8. Japan's real growth will drop sharply in 1974 because of underlying cyclical trends, the continuation of anti-inflationary efforts for at least a few more months, and the contractionary impact of higher oil prices on Japan as well as other countries. We believe that, if Tokyo is slow to respond to the prospective problem of inadequate demand, growth in real output will decline to only 3%—the lowest rate since the mid-1950s. If Tokyo moves decisively within the next few months to stimulate demand, the growth rate is expected to reach about 5%. The first sign of a change probably will be an easing of direct controls on bank lending.



9. Several indicators suggest that a slump in private investment spending, which constitutes one-third of GNP, is already developing. New orders for machinery and equipment dropped substantially in December, and several major firms have pared investment plans. A cyclical decline in inventory accumulation already appears to be under way and probably will accelerate as demand slips. In addition, the growth of personal consumption will probably slow considerably during the next six months. New taxes and higher gasoline prices are already cutting into motor vehicle sales.

10. With the anticipated drop in economic growth, Japan faces a doubling in the unemployment rate, to about 2.0%—the highest rate in years. The added unemployment probably will not be serious politically, because little of it will involve established workers who are part of the "life-time" employment system. Most affected will be young women who typically work three or four years before marriage.

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Little Relief from Rising Prices

11. Reducing the inflation rate at all will be difficult because industry will encounter more severe cost pressures this year than last. The recent oil price hikes will boost industrial production costs directly by about 5% and indirectly by perhaps a similar amount. Moreover, unit labor costs probably will increase appreciably. The labor unions are pressing for 30% wage increases and probably will get gains of 20%-25%. Labor productivity gains will be small, compared with last year, because output will increase less rapidly. If Tokyo forces firms to partly absorb cost increases by cutting profit margins, investment spending and economic growth will be set back even more than is now anticipated.

Resisting a Trade Deficit

12. Tokyo hopes to maintain a small trade surplus this year despite the huge increase in oil import costs. Although the value of imports other than oil is expected to change little, the overall import bill will rise an estimated one-third, to $43 billion, because of higher oil prices. Japan will have to raise export earnings by 20% just to balance the trade account, and this growth will have to be mainly in export volume. Japanese firms will want to stabilize the dollar prices of their goods to gain a competitive edge on other exporters. They will be aided in doing so by the depreciation of the yen, currently down by 11% on a trade-weighted basis from the early 1973 level.

13. The Japanese are in a position to mount a strong export drive and seem to be moving in that direction, but probably cannot raise exports as much as 20%–a 15% growth appears more likely. As in 1971, when Japan increased export volume by 20%, weakening domestic demand this year will induce many firms to look abroad for markets. The automobile industry, for example, hopes to increase overseas sales volume by one-third, and the steel industry expects to have substantially more steel available for export this year. The Japanese continue to have the advantages of an efficient international marketing system.

14. Japanese exporters almost certainly will concentrate more on the US market this year than last. The physical volume of sales to the United States fell by an estimated 10% in 1973: (a) export industries in many instances were straining against capacity, and (b) Japan found it more profitable to sell to other countries, since the yen had appreciated much less against their currencies than against the dollar. The yen's depreciation relative to the dollar over the past several months has once again increased the profitability of sales in the US market.

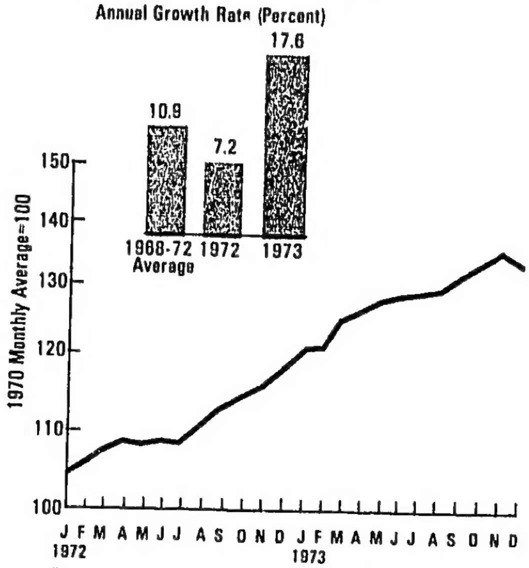
Protecting Exchange Reserves

15. On balance, we think a $2 billion trade deficit is likely this year. Japan would then have a current account deficit of about $6 billion and a strong motive to reduce sharply the net outflow of long-term capital, which was nearly $10 billion last year. New restrictions have already been placed on overseas lending by Japanese banks, and domestic firms are being permitted to borrow abroad for the first time in several years. Since the last measure was announced a few weeks ago, the Ministry of Finance has received 120 applications to float bonds abroad. Through such moves, Tokyo expects to reduce net long-term capital outflows to $4 billion in 1974. This would still result in a basic balance deficit of $10 billion, and Tokyo may thus decide on even steeper cuts in capital outflows.

16. Even with $11.6 billion in official reserves and about $10 billion in non-official reserves—mostly dollar deposits in commercial banks—the Japanese have cause for concern about the decline in official holdings. Tokyo wants to keep its official reserves from dropping below $10 billion. Nonetheless, this level probably will be reached before the year ends unless even more is done to boost capital inflows or restrict outflows. The Japanese will be inclined to seek funds from any type of system devised to recycle Arab dollars and will substantially increase their short-term borrowing abroad. The Japanese, for example, are already stepping up borrowing in the US acceptance market to help finance their foreign trade. Tokyo will also try to attract Arab oil dollars, but probably will meet with little success because it lacks a well-developed international money market.

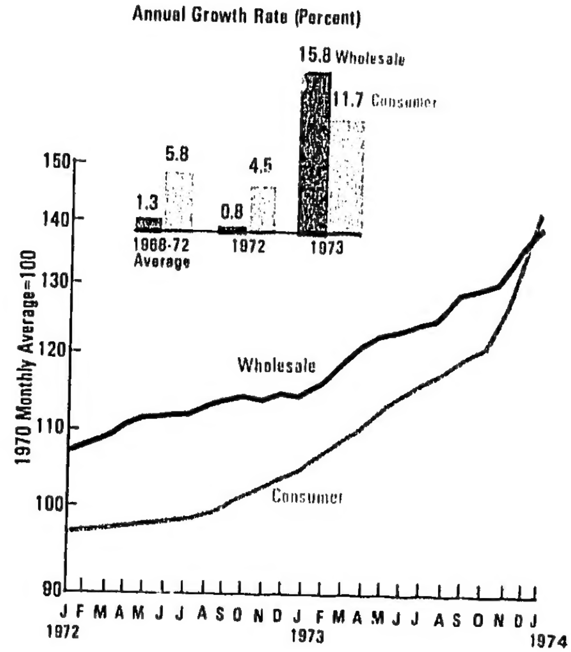
JAPAN: DOMESTIC ECONOMIC INDICATORS

INDUSTRIAL PRODUCTION*

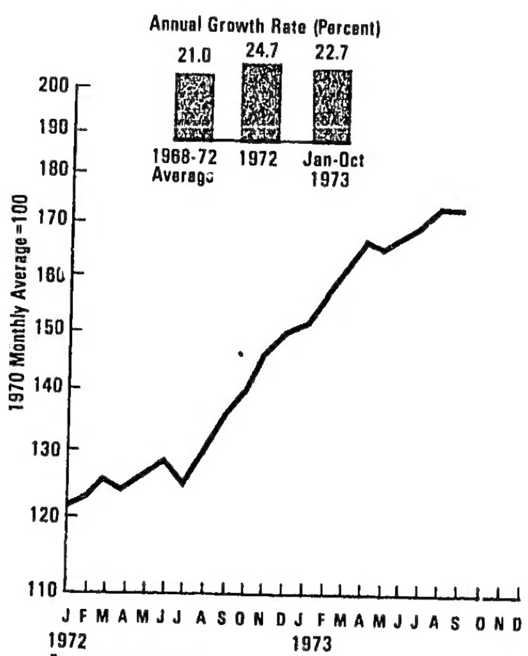


*Seasonally Adjusted

PRICES



MONEY SUPPLY*



*Seasonally Adjusted

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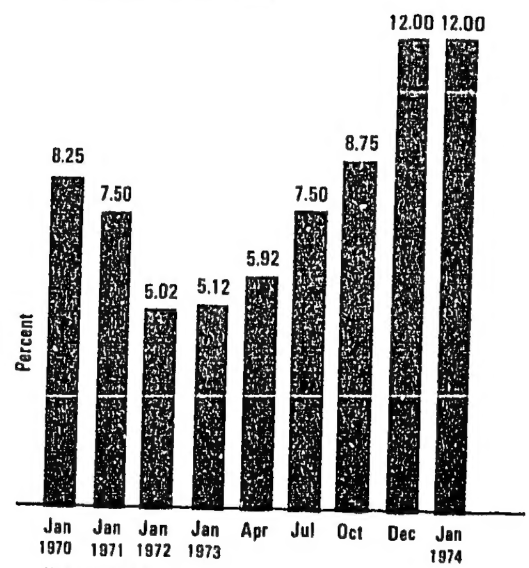
MONEY MARKET RATES

Interest Rate for Call Money



Note: End of Period.

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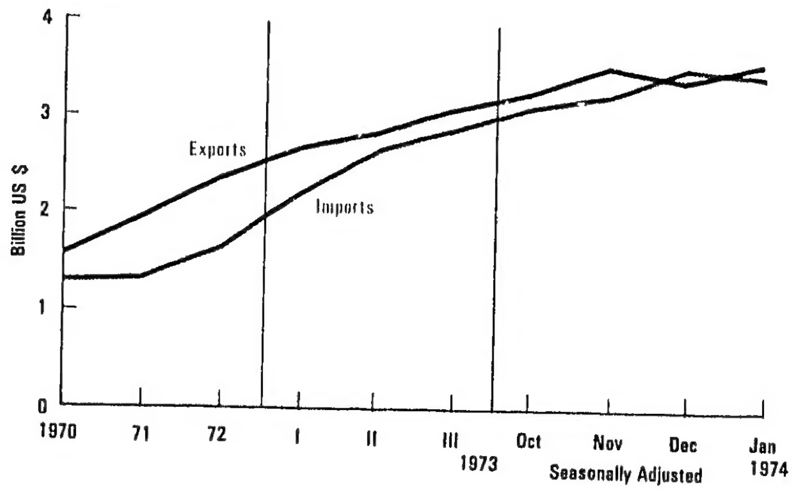
JAPAN: EXTERNAL ECONOMIC INDICATORS

VALUE OF TRADE

Monthly Average



TRADE BALANCE

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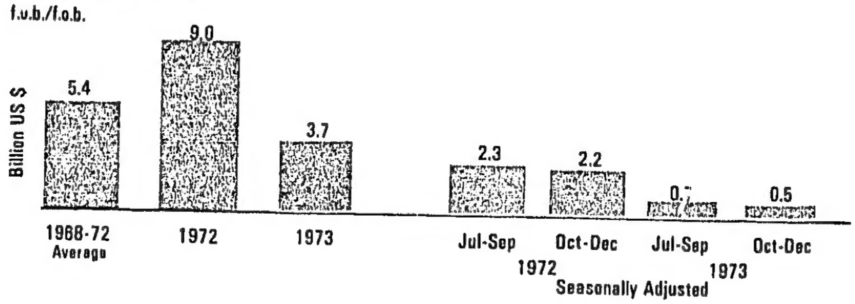
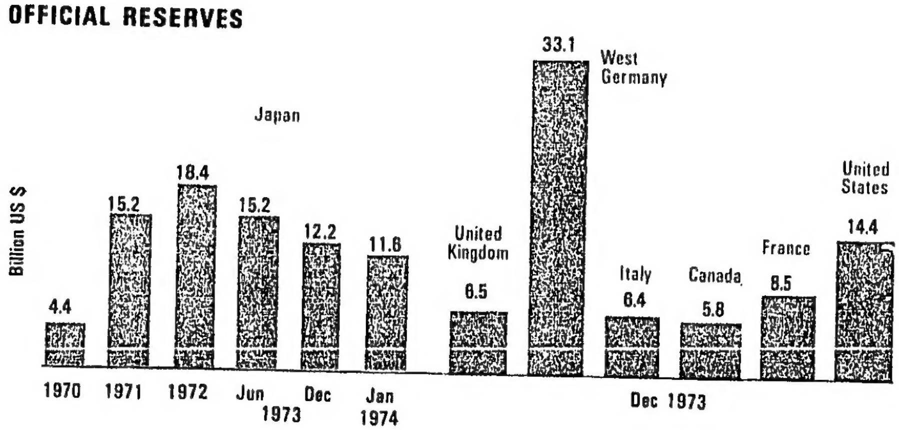


OFFICIAL RESERVES



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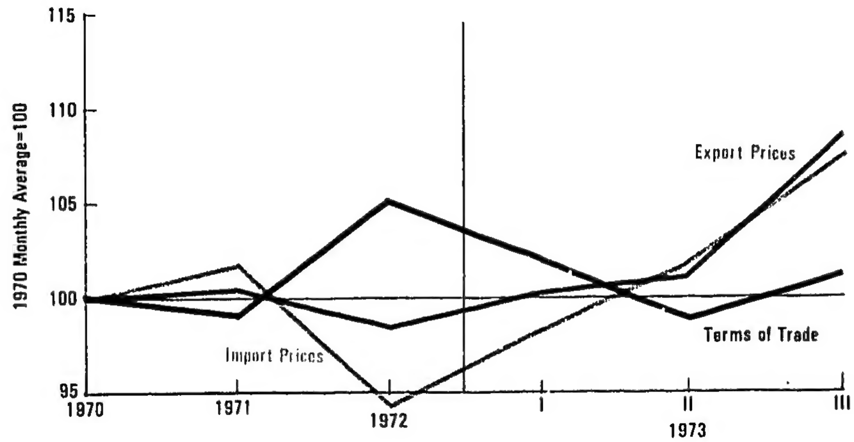
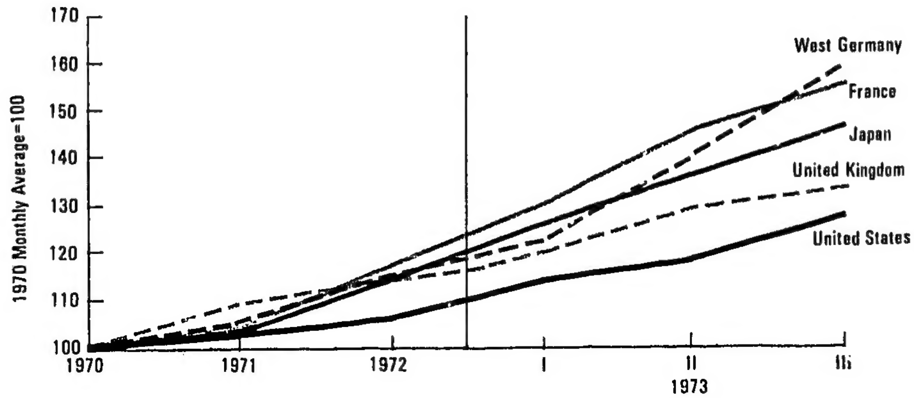
JAPAN: EXTERNAL ECONOMIC INDICATORS

TERMS OF TRADE

National Currency

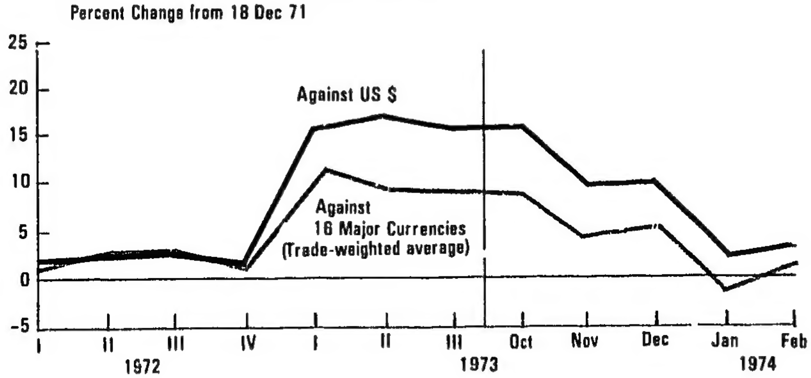


EXPORT PRICES IN US $



EXCHANGE RATES FOR THE YEN

Percent Change from 18 Dec 71



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